A lively discussion ensued in the wrap-up session, focusing on five questions. First, should the central bank concentrate on the asset side or the liability side of banks’ balance sheets? Second, what lessons can we draw from the Basel Capital Accords? Third, what have we learned from history? Fourth, which issues require consideration in economic modelling? Fifth, what is the role of the central bank in a world where the financial system function is important?

In his opening remarks, Charles Freedman described the emphasis of central banks as having shifted from assets to liabilities and back again to assets; these shifts paralleled changes in the operational target of monetary policy. In the second round of discussion, he clarified that the shift back to the asset side should not be overstated. Claudio Borio agreed that central banks should also be concerned with the liability side. But he argued that it is possible to predict banking crises using a number of financial indicators, including asset prices. He noted research from the Bank for International Settlements that found that the overextension of credit during booms tended to be associated with high-cost financial crises. David Longworth asked the panel what they thought the range of possible policy responses to a credit boom should be. Borio responded, noting that people believe risk is low during credit booms, and thus the perception of the value of implicit subsidies from deposit guarantees is also low. The central bank must limit the bailout guarantees (explicit or implicit), since these constitute a first-order moral-hazard problem, as opposed to the second-order problem of the lender of last resort.

* Prepared by Raphael Solomon.
John Murray began the general discussion of the Basel Accords by expressing two concerns about extending national regulations to the international arena. First, some national regulations have not been very successful in achieving their goal. Second, the ability to control the consequences of international regulation is much less than the comparable ability for national regulation. Borio suggested that a flexible capital requirement, which takes into account business cycle fluctuations, might improve on the existing regime. He noted that there have been two intangible benefits of the Basel Accords: an improved credit culture and longer retention of data. Borio noted that banks used to throw away records of loan decisions after three to four years!

Angela Redish set the stage for the discussion about history in her opening remarks, where she noted that one large benefit of the conference was learning how much we still do not know about issues of financial stability. Murray was more optimistic about what policy-makers have learned. He recalled how the preferred method for dealing with financial instability used to be a bank holiday—a policy that conformed to the principle of not feeding a crisis with liquidity. In his view, we have learned this lesson domestically, although we are slower to apply it internationally. Redish argued that drawing inferences from the past has become more difficult because of three important structural changes. First, regulation of the financial sector no longer functions through competition policy. Second, banks used to hold capital but not reserves. Finally, the existence of deposit insurance may also have complicated the environment. Freedman noted that the earlier focus of economists was on individual institutions, not systemic issues, which were equally important. Borio also noted that systemic stability issues are important. Frank Milne argued that some of the same problems we experienced recently, such as the bubble in the dot-coms or the Australian housing market, have parallels going back centuries.

Redish’s opening address introduced the topic of economic modelling, noting that it was still in its infancy. She bemoaned the lack of a conference presentation dealing with the lender-of-last resort function and the interbank markets. During the subsequent discussion, Freedman noted that theoretical models often lag innovations in the financial sector. For example, time deposits were introduced in the 1960s, but models of banking still use demand deposits. For him, the cash-in-advance paradigm has never reflected the “real world.” Redish suggested that we have only just begun to build dynamic general-equilibrium models, recognizing that researchers should build unrealistic models step by step in order to advance. Freedman replied that this reminds him of the statement, “This works in practice but not in theory.” Brian O’Reilly said that he frequently hears the complaint that there are not enough data—a problem that constrains modelling. He suggested
that perhaps we have a lot of information and difficulty processing it. Borio replied that he feels we should use the data we have to better advantage. He added that there is no such thing as absolute certainty, but it should not prevent us from going ahead with modelling.

Freedman began the discussion of the role of the central bank in his opening comments. He informed the audience that the central bank’s competency in financial stability today is the same as it was in monetary policy 30 years ago. Murray said that he found this surprising, given that the lender-of-last-resort function predates the monetary policy function substantially. Borio said that the discrepancy in central bank competencies does not surprise him, because it has to function in a new world today. In the post-war period, there were capital controls and fixed exchange rates. Only now, with unfettered international capital, are the true problems of financial stability coming to light. The liberalization that created this new regime has made banking more difficult to supervise. Walter Engert expressed concern that implicit guarantees to banks and other moral-hazard issues are exacerbating regulatory problems. Borio responded that there is little empirical evidence of this, although it is suggested strongly by the theoretical literature.

Jean-Pierre Aubry remarked that, given the large financial flows to East Asia and to the U.S. stock market, the central bank should comment on market behaviour, even if such comments constitute a blunt instrument. Borio noted that arbitrage can make seemingly targeted instruments ineffective. He further explained that the problem of who should comment is also difficult—the central bank says that certain issues are up to the regulators, and the regulators say that these issues are the responsibility of the central bank. But failing to comment is not acceptable, even though it raises the issue of whether central banks know more than markets. This is because only central bankers can take a long-run view. Freedman agreed but said that such comments are frequently misunderstood or ignored. People ignored Alan Greenspan when he said that the stock market suffered from irrational exuberance. Redish called the idea of the central bank commenting on the markets the “Leave It to Beaver” policy.